

Table 1 - Summary of Warrants Issued Pursuant to the Indenture

Instrument	Date	Series	Original Principal Amount
Indenture	February 1, 1997	1997-A Sewer Revenue Refunding Warrants	\$211,040,000
		1997-B Taxable Sewer Revenue Refunding Warrants	\$48,020,000
		1997-C Taxable Sewer Revenue Refunding Warrants	\$52,880,000
First Supplemental Indenture	March 1, 1997	1997-D Sewer Revenue Warrants	\$296,395,000
Second Supplemental Indenture	March 1, 1999	1999-A Sewer Revenue Capital Improvement Warrants	\$952,695,000
Third Supplemental Indenture	March 1, 2001	2001-A Sewer Revenue Capital Improvement Warrants	\$275,000,000
Fourth Supplemental Indenture	February 1, 2002	2002-A Sewer Revenue Capital Improvement Warrants	\$110,000,000
Fifth Supplemental Indenture	September 1, 2002	2002-B Sewer Revenue Capital Improvement Warrants	\$540,000,000
Sixth Supplemental Indenture	October 1, 2002	2002-C Sewer Revenue Refunding Warrants	\$839,500,000
Seventh Supplemental Indenture	November 1, 2002	2002-D Sewer Revenue Capital Improvement Warrants	\$475,000,000
Eighth Supplemental Indenture	January 1, 2003	2003-A Sewer Revenue Refunding Warrants	\$41,820,000
Ninth Supplemental Indenture	April 1, 2003	2003-B Sewer Revenue Refunding Warrants	\$1,155,765,000
Tenth Supplemental Indenture ¹¹⁴	August 1, 2003	2003-C Sewer Revenue Refunding Warrants	\$1,052,025,000

The financing transactions were summarized by *The Birmingham News* in a July 10, 2010 table entitled “How Jefferson County’s Debt Ballooned” (herein, “News Debt Table”), included in the Appendix to this report at A-9. The various series of warrants (or “parity securities” under the terms of the Indenture) were not identical to one another, either in their intent or structure. Several of the series of warrants were “refunding” warrants issued to refinance previously-issued series of warrants to lower the County’s interest costs and avoid significant rate increases.¹¹⁵ In

¹¹⁴ There is an Eleventh Supplemental Indenture; this instrument did not involve the issuance of additional warrants but instead altered the terms of the Indenture consistent with certain interest rate swap transactions entered into at that time. The Eleventh Supplemental Indenture also produced additional funds for capital improvements.

¹¹⁵ The refunding warrants included the Series 2002-C Refunding Warrants, the Series 2003-A Refunding Warrants,

what the federal court later called a “risky attempt”¹¹⁶ to minimize the required interest payments and further postpone the inevitable rate increases, beginning with the Series 2002-A Sewer Revenue Capital Improvement Warrants, the County began to issue substantial amounts of variable rate demand warrants and auction rate warrants rather than more traditional fixed rate warrants.¹¹⁷

The variable rate demand warrants bear interest at fluctuating rates generally determined by market interest rates, and interest payments are due at various times throughout the year. The variable rate demand warrants are subject to optional or mandatory tender by the warrant holders from time to time; when that occurs, a “remarketing agent” selected by the County and acting as its agent attempts to “remarket” the variable rate demand warrants.¹¹⁸ The County agreed in the Indenture to maintain a liquidity bank or banks as a buyer of last resort in case the remarketing agent was unable to successfully remarket the variable rate demand warrants; the liquidity banks agreed, through Standby Warrant Purchase Agreements secured by the net revenues of the System, to purchase the variable rate demand warrants from the remarketing agent.¹¹⁹ Once a liquidity bank purchases the variable rate demand warrants, they become “Bank Warrants,” subject to higher interest rates than variable rate demand warrants that are not Bank Warrants.¹²⁰

The auction rate warrants bore interest at fluctuating rates set by periodic auctions.¹²¹ The interest rate was set by the lowest interest rate at which all of the warrants were offered for sale by current holders of the warrants. If the auctions failed, the interest rate would be set at the Maximum Auction Rate as defined in the Indenture, as amended.

As of March 2008, the County had approximately \$3.223 billion in outstanding sewer warrants. These warrants fell into the following classes:

the Series 2003-B Refunding Warrants and the Series 2003-C Refunding Warrants.

¹¹⁶ Federal Action, Memorandum Opinion, Doc. # 100 at 4 (June 12, 2009) (herein, the “Federal Opinion”). The Federal Opinion is discussed in more detail in Section II.G *infra*.

¹¹⁷ Federal Opinion at 4-5.

¹¹⁸ Federal Joint Submission at ¶ 67; *see also* Fourth Supplemental Indenture at § 2.6(a).

¹¹⁹ Federal Joint Submission at ¶ 69; *see also* Fourth Supplemental Indenture at § 2.6(e).

¹²⁰ Federal Joint Submission at ¶¶ 72, 74.

¹²¹ *Id.* at ¶ 74.

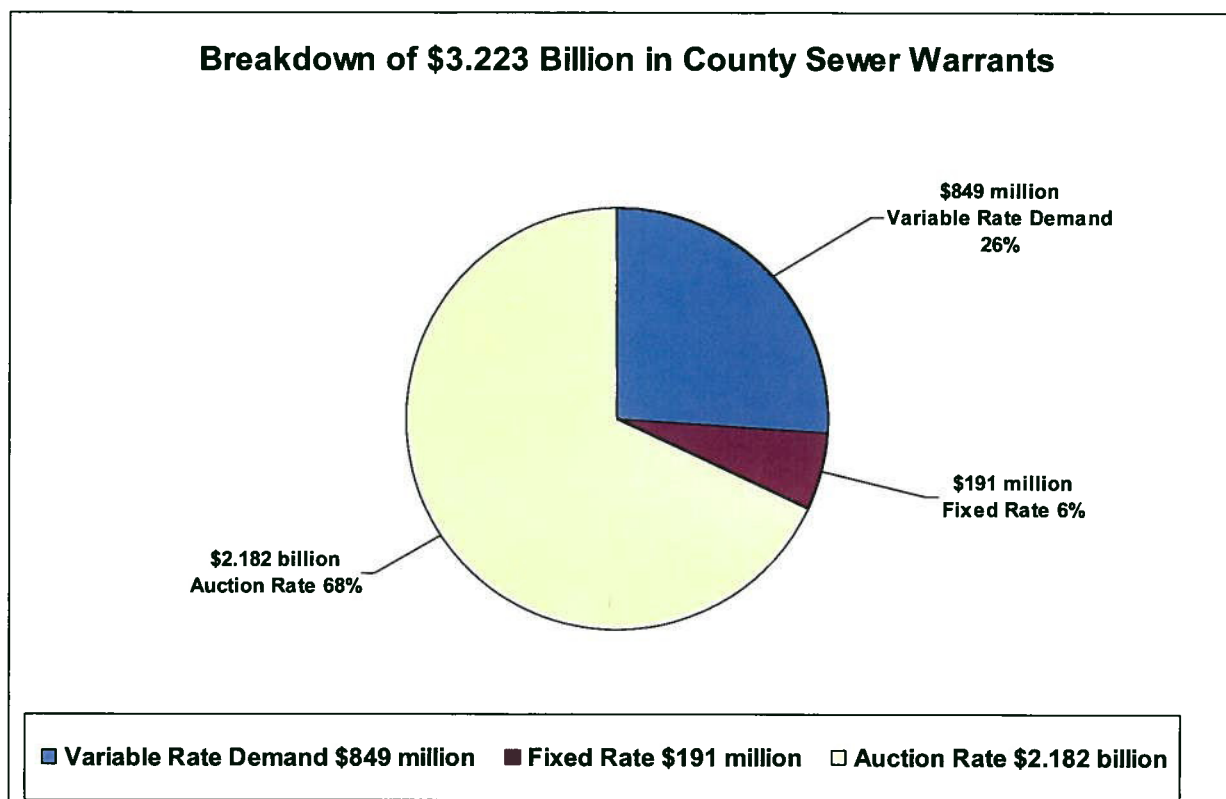


Figure 2 - Breakdown of \$3.223 Billion in County Sewer Warrants

When issuing the warrants, the County also purchased municipal bond insurance policies to make its warrants more marketable and to minimize its interest rate costs.¹²² These policies provided that if the County was unable to make payments of principal and interest required by the Indenture, the bond insurers, Syncora Guarantee (formerly known as XL Capital Assurance, Inc.), Assured Guarantee Municipal Corporation (formerly known as Financial Security Assurance Holdings ("FSA")), and Financial Guaranty Insurance Company ("FGIC"), would make these payments.¹²³ The Indenture provides generally that, upon payments to warrant holders under their respective policies, the bond insurers would become owners of the warrants (and the right to interest from the warrants) and subrogated to the rights of the warrant holder. As of March 2008, FGIC insured 54% of the outstanding warrants, Syncora insured 35%, and FSA insured 11%.

To achieve a synthetic fixed rate structure, the County also entered into several interest rate swaps from 2001-2004 with several investment banks as a hedge against market interest-rate exposure and to offset its debt service payments. An interest rate "swap," at its most basic definition, is an agreement by which one party (the "Issuer") agrees to exchange interest payments from a fixed interest rate (the "Fixed Position") with another party (the "Swap Counterparty") for the interest payments from a variable interest rate (the "Floating Position"), with the amount of interest paid by both parties being calculated off of a notional, or imaginary,

¹²² Federal Opinion at 6.

¹²³ Federal Joint Submission at ¶¶ 51-60.

principal amount.¹²⁴ When interest rates fall below the Fixed Position, the Issuer ends up with a net payment obligation to the Swap Counterparty, which is obligated to pay the lower Floating Position. Conversely, when interest rates rise above the Fixed Position, the Issuer is entitled to a net payment from the Swap Counterparty, which is now obligated to pay the higher Floating Position. In the County's case, it primarily took the "Fixed Position" in the example above, and the total combined notional value of its swaps was approximately \$5.5 billion.¹²⁵ Its goal in doing so was that, by receiving the variable rate payments from the swap issuer, it was hedging against the potential of increasing interest payments due under the variable rate warrants. As noted below, this plan backfired when market interest rates generally dropped to historically low levels in 2008. All swap agreements have since been terminated.

D. Criminal Activity.

As is widely known, criminal activity plagued both the financing and construction activities initiated as part of the County's efforts to comply with Consent Decree. That criminal activity has been widely reported, is a matter of public record, and need not be recounted in detail here. Four County Commissioners, six former County employees (including the former head of the ESD), several contractors and firms that did business with ESD, and two local investment bankers associated with the financing of the sewer debt and swap transactions, have been convicted of federal bribery and conspiracy crimes for their actions.¹²⁶ The criminal convictions were summarized by *The Birmingham News* in a July 30, 2010 table that is included in the Appendix at A-10.

It is not the Receiver's role to adjudge the guilt or innocence of any of the alleged wrongdoers, or to quantify the cost of any criminal conduct which occurred. Those determinations will ultimately be made in the various lawsuits in which the County and certain creditors are seeking damages for the alleged wrongdoing. Criminal conduct likely increased the cost of the financing activities the County initiated to comply with the Consent Decree. An additional factor which also substantially increased the County's construction costs is the corruption and incompetence present at the County and ESD level. These actions also diminished the effectiveness of the County's efforts to comply with the Consent Decree. The effects of this criminal activity, corruption and incompetence were clearly evident in many of the problems outlined in the BE&K Report (e.g., ESD's irregular bidding procedures, little to no

¹²⁴ For a short, helpful explanation of interest rate swaps, see Douglas Skarr, California Debt and Investment Advisory Commission, *The Fundamentals of Interest Rate Swaps* (October 2004), <http://www.treasurer.ca.gov/cdiac/reports/rateswap04-12.pdf> (last accessed June 5, 2011).

¹²⁵ Validation Order at 9; BE&K Report at 12-12.

¹²⁶ Federal Opinion at 5-6. In addition, the Securities and Exchange Commission ("SEC") charged J.P. Morgan Securities, Inc. ("JPMorgan"), and two of its former managing directors, Charles LeCroy and Douglas MacFaddin, for their roles in an unlawful payment scheme to win business involving municipal bond offerings and swap agreement transactions with the County. See SEC Release No. 2009-232 (Nov. 4, 2009), available at <http://www.sec.gov/news/press/2009/2009-232.htm>. JPMorgan settled the SEC's claims against it by making a payment to the County of \$50 million "for the purpose of assisting displaced County employees, residents, and sewer ratepayers," paying a fine of \$25 million (which was later distributed to the County), and by cancelling \$647 million in claimed swap termination fees. See SEC Order *In the Matter of J.P. Morgan Securities Inc.*, SEC Administrative Proceeding File No. 3-13673 (Nov. 4, 2009). The SEC's suit against LeCroy and MacFaddin remains pending in the United States District Court for the Northern District of Alabama.

project supervision or budgeting, the use of only a small group of contractors and engineers, etc.).

E. System Rate History Since 1997.

The Indenture contains a covenant (the “Rate Covenant”)¹²⁷ in which the County agreed to, among other things, maintain rates sufficient to pay the indebtedness on the warrants and provide for the payment of the System’s operating expenses. The Rate Covenant contains a formula and procedure by which the County agreed to automatic annual increases of sewer rates in order to comply with the Rate Covenant.¹²⁸ The County Commission adopted a resolution on February 12, 1997, implementing the Rate Covenant and providing for automatic increases in sewer rates as necessary to comply with the terms of the Indenture. This resolution was in place until it was suspended by the Commission in December 2008.¹²⁹

However, on at least two occasions, the Commission passed resolutions announcing the Commission’s decision to implement a rate increase *less* than the rate increase required under the Rate Covenant automatic formula the Commission adopted in 1997. On December 2, 2003, the Commission passed a resolution stating the Rate Covenant formula required a rate increase “in excess of 14%” be implemented effective January 1, 2004, but the Commission had determined instead to implement a 10% rate increase.¹³⁰ On December 7, 2004, the Commission passed a similar resolution stating the Rate Covenant formula required a rate increase “in excess of 13%” beginning January 1, 2005, but the Commission had decided to instead implement a 10% rate increase.¹³¹

From 1997 through the present, the Commission implemented the following annual volumetric rate increases:¹³²

¹²⁷ See Indenture at § 12.5.

¹²⁸ *Id.*

¹²⁹ Cams Dep. 17:4-18:23, July 20, 2010; Hulsey Dep., Exh. 40, Feb. 9, 2009.

¹³⁰ Resolution dated December 2, 2003, Minute Book 143, pp. 322-23.

¹³¹ Resolution date December 7, 2004, Minute Book 146, pp. 504-05.

¹³² Special Masters Report at 38.

Table 2 - Summary of Rate Increases From 1997 to Present

Year	Sewer Use Rate (Ccf)	% increase
1997	\$1.78	N/A
1998	\$1.88	5.6
1999	\$2.20	17.0
2000	\$2.48	12.7
2001	\$3.01	21.4
2002	\$3.53	17.3
2003	\$4.90	38.8
2004	\$5.39	10.0
2005	\$5.93	10.0
2006	\$6.35	7.1
2007	\$6.87	8.2
2008	\$7.40	7.7
2009	\$7.40	0
2010	\$7.40	0
2011	\$7.40	0

Volumetric sewer rates have not been increased since January 2008, and all other sewer charges have also remained substantially the same since that time. As noted below, this failure to raise rates at all in the last three-plus years – much less in any sort of meaningful manner – has only exacerbated the System’s debt problem and made any sort of global solution that much more difficult.¹³³

In fact, the County Commission has repeatedly ignored or refused to implement the advice of several experts and consultants – including all of those retained by the County – recommending rate increases for the long term financial stability of the System. These recommended rate increases since 2002, and the County’s responses, are summarized in the following table:

¹³³ See discussion beginning at Section IV.A *infra*.

Table 3 - Recommended Rate Increases and County Response from 2002 to Present

Date/Report	Recommendations	County Response
<p>2002 Krebs Report – The Nov. 2, 2002 report of County consultant Paul B. Krebs & Associates (“Krebs”) projected that System funding would be adequate <i>if rates were increased as recommended.</i></p>	<ul style="list-style-type: none"> • 2003: 43% increase to \$5.05¹³⁴ • 2004: 24% increase to \$6.26 • 2005: 14.6% increase to \$7.18 • 2006: 9% increase to \$7.83 • Total increases for the period: \$4.30 or 122% 	<ul style="list-style-type: none"> • 2003: 38.8% increase to \$4.90 • 2004: 10% increase to \$5.39 • 2005: 10% increase to \$5.93 • 2006: 7.1% increase to \$6.35 • Total increases for the period: \$2.82 or 80%
<p>2003 Krebs Report – The March 31, 2003 Krebs report notified the Commission that, <i>even with no additional borrowing</i>, System funding needs would rise approximately 89% from 2002-2008, and the System was in dire need of additional funds.</p>	<p>While the report did not recommend specific additional rate increases, it did acknowledge that rate revenue would have to be the principal source of funding. The report recommended the County implement several rate structure changes as a way to increase rate revenues, such as eliminating the 15% residential discount, and updating the impact fee structure.</p>	<p>The County did not implement any of the rate structure changes recommended in the report.</p>
<p>2003 BE&K Report¹³⁵ – In late 2002, BE&K estimated it would cost an additional \$611 million (over and above existing debt) to complete the improvement program.</p>	<p>BE&K recommended that the County increase rates by 12.5% yearly from 2004 to 2011.</p>	<p>The County funded less than half of what was recommended. Rates were increased by 10% in 2004 and 2005, 7.1% in 2006, 8.2% in 2007 and 7.7% in 2008. In late 2008, the Commission suspended further rate increases, and rates have not been increased since that time.</p>
<p>2007 Red Oak Consulting Report – Red Oak, retained by the County, recommended that it choose one of five different scenarios for annual rate increases from 2008 to 2010.</p>	<p>The scenario that called for the lowest level of increase required an increase in 2008 of 8%, then 6.3% in 2009, and 5.5% in 2010. The scenario that called for the highest level of rate increases required increases from 2008 through 2010 of 50.4%, 16.4%, and 6.7%, respectively.</p>	<p>No increase. The County suspended all rate increases in 2008.</p>
<p>2008 Draft Raftelis Report – In June 2008, Raftelis Consulting was hired by the County to examine the reasonableness of the County’s then-existing rates.</p>	<p>Although Raftelis was not asked to make rate increase recommendations, the draft report stated that it would be imprudent for the County not to consider rate increases in the near term. The firm sent a letter to the County Commission recommending the County at least increase sewer rates at the level equal to the Consumer Price Index, (2.22%), to reflect a cost of living adjustment.</p>	<p>No increase. The County did not increase rates at all after 2008.</p>

¹³⁴ These percentage and dollar increases in this chart refer to the base volumetric charge per Ccf for residential customers with the standard 5/8 inch meter.

¹³⁵ The BE&K Report is discussed in detail *supra* at Section II.C.1.

Raftelis 2010 Report – In 2009, the County hired Raftelis Consulting to perform a cost of service study and make recommendations for future rate increases to meet System funding needs.	Raftelis recommended the County implement an immediate 6.76% volumetric rate increase, and increase the minimum charge from \$2 to \$13.	No increase. The County did not increase rates at all after 2008.
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The County's hostility to rate increases has a long and consistent history. Included in the Appendix at A-11 is a table summarizing the County's responses to rate recommendations from 1901 to the present. As the table above demonstrates, since 2002 the County has received advice from a host of experts and consultants, and that advice was consistent – the County had to raise its sewer rates to preserve the long term financial viability of the System. The County's response to that advice was also consistent – it either refused to raise rates at all, or failed to raise rates to the full extent recommended.

The 2003 Krebs Report spelled out exactly the issues facing the System and the need for immediate rate increases to meet the drastic future increases in debt costs that would occur due to the back-loaded structure of the County's financing. The consequences of the County's buy-now, pay-later strategy were beginning to kick in. Krebs predicted that by 2006, the System's capital needs would increase by 70 percent, and that the County's system-related debt could total almost \$3.2 billion. Krebs warned the County – a full five years before its default – that:

Regardless of the source from which the needed revenues must ultimately arise, **they will have to be generated**, and the plan for generating them cannot be popular with any of those who will be affected by an increase in taxes or user fees. **Nevertheless, when the alternative of obtaining revenues through a plan over which the Commission has some control is compared with the action of a receiver should the system go into default, there can be little question as to which course of action would be preferable. There can also be no debate about the urgency for action;** this is not a matter on which action can be long deferred without serious consequences.¹³⁶

Yet the County ignored Krebs's advice (and, in fact, as U.S. District Judge David Proctor found, suppressed dissemination of the 2003 Krebs Report)¹³⁷ – as it generally ignored the advice of every professional that recommended increases in sewer rates. The County took this path despite the fact that it had already borrowed billions of dollars secured only by the System – and then proceeded to borrow more. Stated another way, the County borrowed billions of dollars, based on the promise that it would increase rates to required levels, and then refused to take the legal and logical actions required to repay those monies. As Judge Proctor noted after the County suspended operation of the Rate Covenant, “[i]n the face of consistent input from rate experts that net sewer revenues were inadequate to operate and pay its debt obligations, the County went in the *opposite* direction [of increasing System revenues].”¹³⁸

¹³⁶ Consulting Letter Preceding the 2003 Krebs Report at 4 (emphasis added).

¹³⁷ Federal Opinion at 5, 15-16.

¹³⁸ *Id.* at 18 (emphasis in original).

In 2004, there were significant changes to the makeup of the County Commission and ESD management. As a result of these changes, capital expenditures were greatly reduced as the County resisted any further borrowing.

F. The Crash of the System's Finances and the County's Response.

The County's debt structure began to unravel quickly in 2008 after some of its bond insurers' credit ratings were downgraded. This caused the County's interest costs to soar as the market for the warrants disappeared and auctions on its auction rate warrants failed.¹³⁹ At the same time, the County's hedge – the billions in swap agreements – backfired when the interest rates the Swap Counterparties were required to pay dropped precipitously, sending the County's swap obligations soaring.¹⁴⁰ On February 27, 2008, the County's credit rating was downgraded five levels to the lowest investment grade, triggering a requirement that the County post \$184 million in collateral to its Swap Counterparties, money the County had no ability to post. The next day, the County issued a notice that it could “provide no assurance that net revenues from the sewer system will be sufficient to permit the county to meet the interest rate and amortization requirements of the liquidity facilities.” On February 29, 2008, the rating of the sewer warrants was cut to junk status.¹⁴¹

In April 2008, the County was unable to make certain required principal payments due under certain of the warrants. The County, some of the bond insurers, the Liquidity Banks, and the Swap Counterparties then entered a series of forbearance agreements throughout 2008 under which these creditors agreed to forbear from exercising remedies against the County while it sought a solution to its financial problems. During this time, the County made partial payments to the Liquidity Banks. As late as July 31, 2008, the County approved a resolution declaring that its “synthetic fixed rate structure” had served the County “reasonably well.”¹⁴²

G. Resulting Litigation and Appointment of Receiver.

Following the County's defaults and expiration of the forbearance agreements, and the County's refusal to deposit the System revenues with the Indenture Trustee, the Trustee, Syncora, and FGIC filed suit against the County and the County Commissioners on September 16, 2008, in the United States District Court for the Northern District of Alabama (the “Federal Action”). The Indenture Trustee sought remedies for the County's breaches of the Indenture, including appointment of a receiver.

On November 25, 2008, the District Court appointed John S. Young, Jr. (at the suggestion of the County)¹⁴³ and John Ames (at the suggestion of the Trustee, Syncora, and

¹³⁹ Martin Z. Braud, *Ala. County's Debt Cut to Junk on Credit Squeeze*, BLOOMBERG, Feb. 29, 2008.

¹⁴⁰ Interest rates dropped precipitously in 2008 as the markets began to adjust to the financial crisis enveloping the country. For example, the 1-month LIBOR Rate dropped from 5.02% in December 2007 to 2.51% in May 2008. See http://www.wsjprimerate.us/libor/libor_rates_history.htm.

¹⁴¹ See Braud, *supra* note 139. The downgrade of the warrants also significantly increased the County's interest obligations on the County's auction rate warrants. See Ninth Supplemental Indenture at §§ 1.1 (pp. 3-4, 12), 3.3. The Ninth Supplemental Indenture, which authorized the issuance of \$1.155 billion in refunding warrants, was entered after the County received the 2003 Krebs Report.

¹⁴² Resolution dated July 31, 2008, Minute Book 156, pp. 309-10.

¹⁴³ Federal Opinion at 18 n.14.

FGIC) as special masters (the “Special Masters”) and directed them to provide an evaluation of the legal, economic, business, infrastructure, and capital improvement issues facing the System.¹⁴⁴ The Special Masters filed their report on February 10, 2009 making detailed findings about and recommendations for improving the System. A copy of the Special Masters Report is included in the Appendix at A-12.

On June 12, 2009, the District Court issued an opinion finding that it was required to abstain from the central issue in the case – appointment of a receiver over the System with authority to set sewer rates.¹⁴⁵ A copy of the court’s opinion (the “Federal Opinion”) is included in the Appendix at A-13. While abstaining from appointing a receiver, Judge Proctor made detailed findings of fact concluding that grounds existed for appointment of a receiver. Among other things, he found that:

- The County defaulted under the terms of the Indenture by, among other things, failing to maintain rates sufficient to pay its debt, failing to provide required notices, and failing to make payments into various funds as required by the Indenture.¹⁴⁶
- The County refused to listen to or heed anyone, including its own consultants, who suggested raising sewer rates and the County Commissioner at the time in charge of the System was “largely disengaged [from] any efforts to raise revenue.”¹⁴⁷
- ESD was providing services to customers that were not billed and did not pay (in some cases for up to five or six years) – when it discovered this, the County only sought to collect payment for one year of unbilled service;¹⁴⁸
- The then-County Commissioners “at best, paid lip service” to the recommendations of the Special Masters and were generally disengaged from the sewer debt crisis.¹⁴⁹
- The County suppressed dissemination of the 2003 Krebs Report, which had concluded that the County required additional revenue to meet its then-existing debt obligations – and then borrowed more money.¹⁵⁰
- The County was aware at least as early as 2003 (if not before) that its net sewer revenues were insufficient to service its existing debt, yet did not reveal this information to potential investors.¹⁵¹

In light of the Court’s abstention from appointing a receiver, on July 6, 2009, the District Court granted the plaintiffs leave to seek relief in Alabama state court.¹⁵²

¹⁴⁴ Order Appointing Special Masters, Federal Action, Doc. # 41 (Nov. 25, 2008).

¹⁴⁵ Federal Opinion at 55.

¹⁴⁶ *Id.* at 13.

¹⁴⁷ *Id.* at 17-19.

¹⁴⁸ *Id.* at 22.

¹⁴⁹ *Id.* at 18-19.

¹⁵⁰ *Id.* at 4-5, 15-16.

¹⁵¹ *Id.* at 15-16.

¹⁵² Order, Federal Action, Doc. # 102 (July 6, 2009).